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IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

SECOND STRUCTURAL ADJUSTMENT LOAN
Loan No. 43990-KO

May 25, 2000

CURRENCY EQUIVALENTS

(as of May 25, 2000)
Currency Unit = Won (W)
US$1.00 = W1,127

ACRONYMS AND ABBREVIATIONS

ADB	-	Asian Development Bank
BIS	-	Bank for International Settlements
BOK	-	Bank of Korea
CAS	-	Country Assistance Strategy
Chaebol	-	Conglomerate
CFSRL	-	Corp. & Fin. Sector Restructuring Loan
ERL	-	Economic Reconstruction Loan
FSC	-	Financial Supervisory Commission
FSS	-	Financial Supervisory Service
FTA	-	Fair Trade Act
G-7	-	Group of seven industrial countries including: the U.S., U.K., Canada, Germany, France, Italy and Japan
GOK	-	Government of Korea
ICR	-	Implementation Completion Report
IMF	-	International Monetary Fund
KAMCO	-	Korean Asset Management Corporation
KDIC	-	Korean Deposit Insurance Corporation
KFTC	-	Korean Fair Trade Commission
LIBOR	-	London Inter-Bank Offer Rate
MOFE	-	Ministry of Finance and Economy
NGO	-	Non-Governmental Organization
NPL	-	Non-Performing Loan
SAL	-	Structural Adjustment Loan
SBA	-	Stand-By Arrangement
SFO	-	Special Financial Operations

FISCAL YEAR

January 1 - December 31

Vice President	Jemal-ud-din Kassum, EAPVP
Country Director	Sri-Ram Aiyer, EACKF
Sector Director	Homi Kharas, EASPR
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Preface

The Second Structural Adjustment Loan (SAL II) to the Republic of Korea in the amount of US$2 billion was approved on October 22, 1998. The loan was made effective and the first tranche of $1 billion disbursed on October 23, 1998. The second tranche of $1 billion was disbursed on May 11, 1999. The loan closed on June 30, 1999, which was the original closing date.

SAL II was the third in a series of World Bank adjustment loans in support of the major structural reform program that the Government of Korea launched in response to the economic crisis. It built on the reforms initiated under an Economic Reconstruction Loan (ERL) approved on December 23, 1997, and continued under a Structural Adjustment Loan (SAL I) approved on March 26, 1998.

The primary author of this Implementation Completion Report (ICR) was Richard Carroll. Zia Qureshi was the Task Manager and supervised the preparation of the ICR. The report is based on interviews with the task team and the concerned managers and materials from the project file.

Project ID: KR-PE-56521	*Project Name:* Structural Adjustment Loan II
Team Leader: Zia Qureshi	*TL Unit:* EACKQ
ICR Type: Core ICR	*Report Date:* 5/25//00

1. Project Data

Name:	Structural Adjustment Loan II	*L/C Number:*	43990
Country/Department:	Korea	*Region:*	East Asia
Sector/subsector:	PREM		

KEY DATES

			Original	*Revised/Actual*
PCD: June 29, 1998		*Effective:*	October 23, 1998	
Appraisal: August 31, 1998		*MTR:*	NA	
Approval: October 22, 1998		*Closing:*	June 30, 1999	

Borrower/Implementing Agency: Ministry of Finance and Economy
Other Partners:

STAFF	Current	At Appraisal
Vice President:	Jemal-ud-din Kassum	Jean-Michel Severino
Country Manager:	Sri-Ram Aiyer	Sri-Ram Aiyer
Sector Manager:	Homi Kharas	Masahiro Kawai
Team Leader at ICR:	Zia Qureshi	Zia Qureshi
ICR Primary Author:	Richard J. Carroll	NA

2. Principal Performance Ratings

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HL=Highly Likely, L=Likely, UN=Unlikely, HUN=Highly Unlikely, HU=Highly Unsatisfactory, H=High, SU=Substantial, M=Modest, N=Negligible)

Outcome:	S
Sustainability:	L
Institutional Development Impact:	S
Bank Performance:	S
Borrower Performance:	S

	QAG (if available)	ICR
Quality at Entry:	S	S
Project at Risk at Any Time:	M	M

3 Assessment of Development Objectives and Design, and of Quality at Entry

3.1 Original Objective

The objectives of the loan were fundamental and far reaching, yet designed for a fast disbursing loan that would deliver BOP assistance in a timely fashion. The overall objective was to help Korea restore financial stability while mitigating the social costs of adjustment and implementing deep structural reforms in the financial and corporate sectors to pave the way for Korea's return to strong and sustained growth.

3.2 Revised Objective

No revisions

3.3 Original Components

SAL II can be distinguished from the previous two operations in that it was implemented over a longer period (2 vs. 1 tranches) and was a deeper and broader operation. The first loan, ERL, was an emergency liquidity transfer that established the broad framework for the rest of the program. SAL I had more detailed conditionality, but also addressed the urgent need to restore market confidence in Korea's economy. SAL II was considerably broader and went much deeper into the elements of medium and long-term economic reform. The components of SAL II were:

- I. Macroeconomic Framework
- II. Financial Sector Reform
- III. Corporate Sector Reform
  - A. Corporate Financial Restructuring
  - B. Corporate Governance, Competition Policies, and Reform and Privatization of State Owned Enterprises (SOEs)
- IV. Labor Market and Social Safety Nets

3.4 Revised Components

No revisions

3.5 Quality at Entry

The QAG assessment of SAL II was satisfactory overall. The QAG assessment noted that although no economic and sector work on Korea had been done by the Bank for some years following Korea's graduation from Bank borrowing, the Bank made effective use of staff who had substantial knowledge of the politics and economy of Korea. SAL II was also nominated by the EAP Region for a 1999 Award for Excellence .

4. Achievement of Objectives and Outputs

4.1 Outcome/Achievement of Objectives

The SAL II program and its achievements were impressive. The fulfillment of SAL II program conditions constituted a response that was rapid and comprehensive. Confidence of the international financial community was restored quickly. The main short-term impact was not only in averting a possible secondary crisis, but also in supporting economic recovery at a rate far ahead of market expectations, with GDP growth in 1999 reaching 10.7 percent. From a longer-term perspective, the deep reforms supported by SAL II addressed key structural and institutional deficiencies that underlay Korea's vulnerability to crisis. These reforms helped lay the foundation for Korea's return to strong and sustained growth and strengthened its ability to withstand future shocks. Given the medium- to long-term nature of fundamental structural and institutional reform, Korea will need to continue its reform program in order to reposition its economy for sustained growth in the context of today's more globalized and competitive world economy. With the substantial progress made on structural reform under the SAL program, a good basis has been laid for Korea to build on. Overall, the breadth, depth and pace of structural reforms implemented by Korea compared favorably with those of other East Asian crisis countries.

Macroeconomic Framework

Macroeconomic indicators rebounded much faster than expected, especially growth. When the exchange rate stabilized in March 1998, the main macroeconomic issue became the recession. With that came a loosening of the Fund position on the fiscal deficit for which the Bank had been arguing, and an increase of social safety net programs. The focus on the recession was well-placed because the drop in domestic consumption and investment was far greater than predicted. The lack of confidence in the economy and a desire to conserve resources by hoarding money had to be halted. Because the banks were restructuring, credit was very tight. SMEs had almost no source of additional capital. By the end of the program, credit growth had resumed.

Table 1: Key Economic Indicators

	1996	1997	1998	Est. 1999	Proj. 2000
Real GDP growth - % change	6.8	5.0	-6.7	10.7	8.0
Gross domestic inv.-% of GDP	37.9	34.2	21.2	26.8	30.0
Gross national saving.-% of GDP	33.5	32.5	34.0	33.0	32.0
CPI Inflation-end-period % change	4.9	6.6	4.0	1.4	1.8
Govt. budget balance - % of GDP	0.0	-1.7	-4.3	-3.5	-3.0
M3 growth - % change	16.7	13.9	12.5	8.0	...
3-year corp. bond yield - end-period	12.6	24.4	8.0	10.0	...
Balance of Payments-US$ billion					
Exports, f.o.b.	130.0	138.6	132.1	145.5	166.0
Imports, f.o.b.	-144.9	-141.8	-90.5	-116.8	-152.9
Current Acct. Balance	-23.0	-8.2	40.7	25.0	9.5
Usable reserves	29.4	9.1	48.5	74.1	95.0
External Debt-Total-US$ billion	164.3	158.1	148.7	136.0	129.6
of which short-term	93.0	63.6	30.7	35.0	36.0
External Debt-% of GDP	31.6	33.2	46.9	33.4	26.8

Source: Govt. of Korea, and World Bank/IMF staff estimates.

Despite the fiscal costs of fighting the recession and the Government-financed restructuring of the financial sector, total public debt as a percentage of GDP is expected to be around 30 percent in the year 2000, far lower than the OECD average. Until the end of 1999 the main concerns were the increase in unemployment, the fall of real wages, and the credit crunch. Unemployment peaked at 8.6 percent in February 1999.

Growth became positive in the first quarter of 1999. The real exchange rate maintained Korea's competitive position. In 1999, consumer confidence returned and the stock market recovered far ahead of the pre-crisis level.

Given the progress in restoring stability and achieving economic recovery, the macroeconomic component of the program is rated highly satisfactory.

Financial Sector Reform

Financial sector reform was a central component of the reform program. Its main short-term impact was the restoration of market confidence as shown by the upgrade of Korea to investment grade prior to compliance with second tranche conditions. For the longer term, SAL II supported fundamental restructuring of the sector. There were several important elements to the financial sector reform component. Overall, progress on this component is rated satisfactory. At the same time, given that a sizable part of the agenda for sector restructuring remains unfinished, it will be important for the Government to sustain the momentum of reform.

- **Restoration of solvency of banking system**. All banks had met or had concrete plans to meet the 8 percent threshold for capital adequacy by the release of the second tranche. All banks, except for two small banks, had complied by end of 1999. Significant steps were taken toward the privatization of Korea First Bank, one of the largest banks in Korea, and a majority stake in the bank was sold to a consortium led by Newbridge Capital in late 1999, affirming the Government's resolve to bring foreign capital and expertise into the Korean banking system and increasing competition. KAMCO purchases of nonperforming assets and KDIC equity injections to help institutions recapitalize were critical to the recovery of the sector. They were funded by GOK's allocation of 64 trillion Won for KAMCO and KDIC for asset purchases and recapitalization purposes.

- **Strengthening of the regulatory and supervisory functions**. FSC and FSS (the operational arm of FSC) provided the organizational structure and TA helped the FSS strengthen its capacity to supervise financial institutions and monitor progress in restructuring and recapitalization. In the newly established FSS, the supervision of the entire financial sector was consolidated in a single agency. Prudential regulations relating to capital adequacy, loan classification and provisioning, and large exposures and connected lending were considerably strengthened.

- **Capital market development**. The program lays the groundwork for developing equity and bond markets to facilitate a shift in corporate finances away from an excessive reliance on bank debt. The measures taken aimed at strengthening the regulatory and institutional framework underpinning the capital market. An action plan to develop bond markets was initiated. In addition, mutual funds and asset-backed securities are now allowed.

Corporate Sector Reform

Corporate Financial Restructuring. This component had four key targets: (i) improve the insolvency regime; (ii) concentrate on restructuring the Top 5 chaebols; (iii) develop a corporate workout system for the other chaebols; and (iv) assist with restructuring of small and medium enterprises. Progress in the insolvency regime was good, with 90 companies undergoing the insolvency process and with the enforcement of rules that make it more difficult for companies to avoid restructuring. In the latter case, for example, the timetable for court decisions on whether to pursue insolvency was shortened from 5 months to 1 month. Building on SAL I, further improvements were made in insolvency laws and the institutional capacity of the insolvency system.

The Top 5 conglomerates were addressed separately because of their large share of the Korean economy and their political connections. These Top 5 chaebols reached agreement with their lead banks on their capital structure improvement plans (CSIPs). Cross guarantees were on track for elimination by March 2000. The CSIPs helped achieve a reduction in the average debt-equity ratio of the Top 5 from 400 percent or higher at the beginning of the crisis to below 200 percent by the end of 1999, except for the Daewoo group which was unable to meet its debt obligations and was forced into restructuring through formal workouts of its major affiliates. In the mid-tier firms, workouts were agreed for about 90 companies, about half of them belonging to chaebols ranked 6-64. For SMEs that had simply continued to roll over their debts, banks created workout programs. The Bank Corporate Financial Restructuring TA loan helped the lead banks develop workout and turnaround capacity.

The FSC supervised an ambitious restructuring plan which set up out-of-court workout programs for distressed companies in the 6-64 chaebol group and other medium to large firms. Workouts were negotiated under the Corporate Restructuring Agreement (CRA), which was signed by 210 bank and non-bank financial institutions in July 1998. The CRA provides a framework of rules and timetable and lays out roles in inter-creditor resolution. Fifty five non-viable affiliates of chaebols, 20 of which were from the Top 5, were identified for mandated exits. Of these 20, there were 7 liquidations, 6 sales and 7 mergers.

Corporate Governance. Corporate governance had two major subcomponents: (i) strengthening shareholders' rights and boards of directors and (ii) improving the accounting and auditing practices in banks and corporations. SAL II witnessed substantial progress in achieving transparency in the previously opaque business practices in Korea. This change represented a radical shift in culture in the corporate sector and in the Government bureaucracy. Secrecy was power for a select few who, by keeping financial records secret, could turn their modest holdings into a controlling interest of a large chaebol. One of the main impacts of the corporate governance component was to begin to undo the ability of shareholders to effectively control companies with a stake of no more than 10 percent, thanks to weaknesses in the regime of governing corporate boards and minority shareholder rights. It was this ability, combined with the lack of transparency, that allowed exploitative practices such as anti-competitive transfers and transactions between chaebol affiliates.

Shareholders' rights. Improving minority shareholders' rights and strengthening the functions and independence of corporate boards aimed at reforming insular boards which ran companies like family businesses. The goal was to shift corporate emphasis from meeting the interests of the controlling shareholder to that of maximizing shareholder value. One verifiable indicator toward that goal was that by SAL II, at least 25 percent of board members were outside directors (this requirement was increased to 50 percent for large corporations). Another was the reduction of thresholds for various minority shareholder actions that was continued from SAL I.

Financial transparency and accountability reforms. There were several major accomplishments that fell under a two-pronged strategy of measures that would produce immediate results, such as adopting international accounting and auditing standards (that will be applied for all financial statements and audits for companies with assets in excess of W7 billion beginning with the financial year 1999), and institutional changes for the longer run, such as the strengthening of the Korea Institute of Certified Public Accountants (KICPA) and the audit committees of boards of directors and establishment of an independent accounting standard setting board. The general goal of reducing the role of government in accounting and auditing was accomplished. The KICPA was strengthened to oversee the accounting and auditing profession. The Korea Accounting Standards Board, a privately initiated organization, is now responsible for setting accounting standards. The expected impact of a rise in disciplinary actions against accountants for inadequate performance of duty did occur, with the expectation that disciplinary actions will subside as the profession continues to assimilate best practices. Large listed companies and all banks are now required to have audit committees of boards of directors and a majority of directors on the committee from outside of the company, two critical measures to achieve transparency. Creating the audit committee, which required amending the Commercial Code, ensures that a quality audit will be done. All companies must comply with the audit requirement by March 31, 2000.

The full impact of these fundamental changes in business culture and practices will take several years to materialize. However, the changes achieved under SAL II have laid the groundwork for greater transparency and efficiency in the corporate sector over the longer term. The legal and regulatory environment for corporate governance was substantially improved and transformed toward international best practice. The strong recovery of the stock market in 1999 may in part have been indicative of the positive investor response to the corporate governance improvements. The surge in foreign direct investment also indicates a positive impact of the reforms.

Competition Policies. The major accomplishment and impact of the competition policies component were the several major laws that were passed and the strengthening of the Korean Fair Trade Commission (KFTC).

- **Fair Trade Act (FTA)**. Amendments to the FTA strengthened its competition provisions, allowed the establishment of holding companies under certain restrictions, and helped the KFTC deal more effectively with mergers and acquisitions, which were important to corporate restructuring.

- **Foreign investment promotion act** (FIPA). The FIPA was an important achievement in liberalizing foreign investment and partly contributed to the stock market rebound. It was also an important move to win confidence of international portfolio managers. Foreign direct investment totaled $8.9 billion in 1998 and $15.5 billion in 1999, sharply up from an average of about $2 billion in the three years prior to the crisis. Overall, the opening of the foreign investment regime supported by the SALs was radical.

- **Deregulation and the Act on Comprehensive Regulation of Cartels**. The Act attempted to eliminate monopolies in some industries. The act will take on greater significance when the legislative framework is developed further to accommodate the privatization of monopolies. In addition, the Deregulation Committee helped eliminate or modify 7,000 of 11,000 regulations that had been identified for review in order to improve the environment for domestic and foreign investment.

- **KFTC strengthening**. Strong capacity building for KFTC linked with best practices was important because one of the major challenges faced by KFTC was the chaebols' resistance to restructuring. The legislative improvements enhanced KFTC's mandate to review the Big Deals (swaps among Top 5 chaebol affiliates), though it continued to face political constraints in effectively dealing with them. KFTC increased its enforcement power through the ability to levy fines, which reached $138 million equivalent by the end of SAL II, a result aided by KFTC's power to obtain corporate financial records. KFTC also significantly improved its capacity to assess mergers, as well as to identify price fixing and unfair trade practices. KFTC also began to be effective in enforcing the ban on the anti-competitive practice of cross holdings in which a subsidiary of a conglomerate would give an unfair advantage to another of its subsidiaries, for example, by selling it inputs at below market prices.

Reform and Privatization of State-Owned Enterprises. GOK embarked on a strong program to reform and privatize state-owned enterprises and increase private participation in infrastructure sectors. The key components of this program were to improve the management structure of SOEs, identify SOEs to be offered for sale along with a schedule for executing those sales, design a strategy to develop the institutional and regulatory framework needed for privatization and SOE reform, and undertake studies in specific infrastructure sectors (telecommunications, power, and gas) to establish regulatory entities and pricing mechanisms.

Overall, the corporate sector reform component is rated satisfactory. But, as in the case of the financial sector, the agenda for corporate sector restructuring is medium term in nature and will require continuation of reform efforts well beyond the period of SAL II.

Labor Market and Social Safety Nets

The program included a comprehensive package of social sector measures, both to mitigate the short-term impact of the crisis on the poor and unemployed and to initiate longer term reform of Korea's system of social protection. The macro indicators pointed to strong success in the social component. The urban poverty rate had been 8.5 percent in the third quarter of 1997, jumped to an estimated peak of 23 percent in the third quarter of 1998 and has since improved to around 13 percent. Unemployment, below 3 percent before the crisis, peaked at 8.6 percent in February 1999 and fell to an average of 4.6 percent in the last quarter of 1999. By April 2000, the unemployment rate had declined further to 4.1 percent. Overall, the labor markets and social safety nets component is rated satisfactory.

Labor markets. A major step taken under SAL I to enhance labor market flexibility was the legalization of layoffs. SAL II supported the full enforcement of the layoff provisions. Further improvements in labor market flexibility were achieved through easing restrictions on the use of contract labor and on manpower leasing. While progress was eventually made on easing restrictions on manpower leasing, political factors delayed action on this measure which required a waiver of the related tranche release condition.

Social Protection. Unemployment insurance coverage was substantially expanded to include unemployed workers of all firms. Envisaged budget increases for public works programs, means-tested, non-contributory income support, and workfare were achieved, resulting in a doubling of social expenditures. The targeting of the social protection programs was improved.

For the longer run, groundwork was laid for major reform of the pension system and health insurance, aimed at improving their equity, efficiency and financial sustainability. The overarching accomplishment supported by SAL II was to establish a reform process for achieving a modern welfare state as opposed to imposing any specific outcome. As the welfare components evolved within a Korean context, the Bank provided technical assistance to make it work. Pension fund management, anti-poverty programs, etc., were supported by ASEM grants (approximately $1m to each). The TA was valuable in exposing officials to international best practices and raising standards to OECD levels (of which Korea is a member).

4.2 Net present Value/Economic Rate of Return

Not applicable

4.3 Financial Rate of Return

Not applicable

4.4 Institutional Development Impact

SAL II supported broader and deeper institutional development that was initiated under the previous operations (ERL and SAL I). This institutional development, including an enhanced financial regulatory and supervisory regime, improved corporate workout and accounting and auditing capacity, a strengthened framework for competition policies and their enforcement, and a stronger and more coherent social safety net system, was an important part of the reform program and is assessed in the Section 4.1 on achievement of objectives. The institutional development objectives of the loan were supported by a complementary TA loan.

5. Major Factors Affecting Implementation and Outcome

5.1 Outside government or IA control

The market turnaround alleviated Korea's need for BOP assistance, but did not undermine its commitment to reform. The reform momentum was maintained as the economy began to recover. The worsening of the political environment along with high unemployment, which continued into 1999, did delay the reduction of some labor market rigidities, but these were implemented later. The resilience of the GOK commitment to reform can be traced to the realization that the old economic paradigm had to change if Korea were to return to a path of strong and sustained growth in today's globalized and more competitive economic environment.

5.2 Within government control

The Government membership in OECD proved to be an important if intangible factor in the Government's reform-mindedness and desire to meet OECD standards. Another factor that was critical since the beginning of the program and continued through SAL II was the leadership of the reformist government. The Head of Government was freer of the alliances with the chaebols than were the previous regimes. The reformist government also sustained Korea's commitment to reform in the midst of a rapidly improving economy and declining Bank leverage.

5.3 Within implementing agency control

One of the most important success factors was the increasing client ownership of the reform program that took place under SAL II. The implementing agencies were instrumental in design and implementation and fully absorbed the elements of the reform program.

5.4 Costs and Financing

The total loan amount was US$2 billion which was disbursed in two tranches, the first on October 23, 1998, the date of effectiveness, and the second on May 11, 1999. The interest rate on the loan is the 6 month USD LIBOR, plus 0.75 percent. There is a 1.5 percent of principal service charge paid on effectiveness, and a standard commitment charge. The loan term is 15 years with five years of grace.

6. Sustainability

6.1 Rationale for sustainability rating

Sustainability is assessed with respect to the two main goals of SAL II: sustain the economic recovery and continue a broader and deeper reform process. On the first count, the recovery of the Korean economy is ahead of expectations and prospects for its sustainability are good. Furthermore, the structural changes implemented under the reform program will better equip Korea to fend off future crises. Sustainability is also fostered by the mass reaction to the shock of the crisis, which left an indelible memory with the population, and has tempered the complacency that might have developed with the strong recovery. Also, as mentioned above, strong client ownership of the reform program augurs well for sustainability. It is possible that unfavorable political developments or premature complacency resulting from the quick economic recovery may slow the pace of further reform in the future, but the reversal of much of the reform implemented under the program is considered unlikely. For these reasons, the sustainability of the SAL II program is considered likely.

At the time of the QAG quality-at-entry review of SAL II, some concern was raised about the sustainability of the program. It was not certain that such an ambitious pace and breadth of reform could be sustained. The implementation record since the March 1999 QAG report has eased this concern. The QAG also raised a concern over longer-term sustainability of corporate restructuring in view of resistance to reform from the Top Five chaebols. However, despite this resistance, the Government has shown determination to push through significant reform. In the case of the second largest chaebol, Daewoo, GOK departed from the past practice of "too big to fail," when Daewoo was forced to go through work-out proceedings. In addition, under the planned follow-up Bank operation, the Corporate and Financial Sector Restructuring Loan (CFSRL), agreed corporate sector reform measures were largely implemented, despite the loan never going to the Board since Korea did not need the financing anymore given its strong economic recovery and build-up of reserves.

Another possible threat to sustainability is the increase in public debt. It is considerably higher than at the start of the crisis, limiting the Government's fiscal room for maneuver in the event of possible future shocks. Fortunately, it is still at a comparatively low 30 percent of GDP.

6.2 Program follow-up

As noted, GOK continued to implement the follow-up CFSRL program even though CFSRL never went to the Board. This was an important demonstration of the Government's recognition of the need to continue financial and corporate sector restructuring, and of its resolve to sustain the reform effort. Sustainability of increasing transparency is ensured by the legal and institutional changes that were made. Another important development is that GOK is firmly supporting further improvements in corporate governance which would increase the likelihood of continued progress. While the adjustment lending phase is now over, the Bank will continue to support the reform program in all the areas covered by the SALs—financial, corporate and social sector reforms—through non-lending, analytical and advisory services under a knowledge partnership with the Korean Government.

7. Bank and Borrower Performance

SAL II had the dual purpose of providing quick disbursing BOP support to Korea to lower the chance of a second wave of crisis and supporting a longer term structural reform program. The Bank managed this dual objective well as the tranche conditions were directly linked to significant impacts, such as legislative and regulatory changes, capacity building, and implementation of social programs. The beneficial impact of some of the fundamental changes, such as in corporate governance, will be fully realized over time as changes in the regulatory and institutional regime translate into actual changes in corporate behavior.

Bank

7.1 Lending. The Bank developed a cooperative relationship with Korean counterparts which was very beneficial to the financial and corporate restructuring program and the development of FSC. In corporate governance, the Koreans went farther in some areas under SAL I than expected, so by SAL II, the Bank was able to recalibrate its program to set more ambitious goals for the component. In other areas, the GOK was more resistant to reforms and the Bank's position was repeatedly challenged. For example, the Bank had to be particularly firm on the establishment of audit committees of boards of directors. The Koreans vigorously debated some reforms, but once convinced, their implementation was equally vigorous.

7.2 Supervision. Close supervision by the Bank contributed to an overall satisfactory implementation of the reform program. In the course of the supervision, Bank staff provided substantial analytical and advisory inputs to the implementing agencies. Program implementation was also helped by the parallel TA loan, especially in corporate and financial reform.

The Bank exerted a great deal of effort to push the Korea First and Seoul Bank privatizations. In reality, neither of the two banks was privatized by the release of the second tranche, but both had letters of intent from potential purchasers to do so. Because of the specific wording of the tranche condition, a waiver of the condition was not required in order to release the second tranche. The

Bank management was confident that the two letters of intent would surely result in at least one privatization transaction (as indeed happened later in 1999).

The Bank demonstrated realistic expectations in allowing financial institutions to achieve capital adequacy with full provisioning in steps. A more ambitious timeframe could have caused a systemic failure by putting too much pressure on the financial and corporate sectors.

7.3 Overall Bank Performance

Bank performance is rated as satisfactory. The progress of Korean reforms compared favorably to any other Asian crisis country. Even though the Bank's leverage waned as the crisis ebbed, the Bank had helped GOK develop and implement a program that is fundamentally reforming the financial, corporate and social sectors. The Bank was firm on policy measures it considered critical despite initial Government resistance to some of them, and pressed for ambitious schedules so that Korea could differentiate itself from other crisis countries. In the end, once policy discussions were concluded, the Government had strong ownership of the reform program. Policy discussions were informed and helped by complementary economic and sector work, including a CEM that developed some of the analytical underpinnings. The T.A. provided in parallel with SAL II was very effective and has provided a vehicle to continue to support reforms beyond the SAL II operation.

The Bank's partnership with the IMF in their joint effort to ease the crisis and help Korea build a path to long-term sustainable growth matured into one of good coordination. Early in the program, the Bank lobbied the IMF successfully to move toward an easing of the fiscal stance to stimulate the economy. Issues also arose initially about the division of labor in areas of structural reform but were resolved. As the program progressed, the Bank and IMF worked together increasingly effectively, the Bank leading the work on corporate restructuring and social protection and working together with the IMF in the financial sector. To ensure close coordination and consistency, the two staffs collaborated actively both at headquarters and in the field, including through joint missions and joint communications with the Government.

Borrower

7.4 Preparation

As a continuation of the overall stabilization, recovery and structural reform program, the GOK's preparation performance during SAL II benefited from successful lending operations under the ERL and SAL I. GOK demonstrated the ability to contribute to the design of, and carry out the conditions of, an increasingly deep and broad reform program.

7.5 Government implementation performance

GOK implementation of the program was satisfactory overall. Implementation of the financial, corporate, and social sector components was generally good, with the Government sometimes exceeding targets and demonstrating a strong commitment to fundamentally change current practices. The depth of GOK's commitment to reform was especially evident in the Daewoo case. GOK did not step in just to bail out Daewoo. The chaebol was allowed to break up and its major affiliates forced to restructure through workouts agreed with creditor banks, which sent the right signal to other corporates which had been avoiding restructuring. Other companies concluded that they would not likely be rescued by GOK, but would need to go through with restructuring and all the pain of taking a loss on assets, overhauling management and restructuring operations.

7.6 Implementing agency

The Korean officials were very disciplined counterparts who carried out the details of the reform components well. There were some delays, but overall implementation performance was satisfactory. Implementing agencies' performance was greatly helped by the availability of TA, especially in meeting the second tranche conditions, such as in supporting diagnostics and reviews.

7.7 Overall Borrower performance

The Koreans proved to be tough negotiators, but once persuaded and committed to reform actions, their follow-through tended to be strong and thorough. Because of the strength of the Korean Government's commitment to reform, widespread change could be achieved in a relatively short amount of time. Koreans showed a high degree of political commitment to reforms led by the President himself. This commitment to reform has extended beyond SAL II with the implementation of much of the reform program agreed under the proposed Corporate and Financial Sector Restructuring Loan (CFSRL), even though the loan did not go to the Board.

8. Lessons Learned

Client ownership is essential to a strong reform program and its sustainability. During the course of the three adjustment operations, GOK developed a stronger ability to design and implement reforms and became increasingly convinced of their necessity to return to a path of sustainable long-term growth. Substantial analytical and advisory input provided by Bank staff in the process of policy discussions, and the depth of the dialogue that took place with the client, helped build client conviction and ownership.

Contact with the private sector and non-government stakeholders enhances the chances for recovery and reform. The Bank team kept in close contact with the thinking and reactions of the private sector, recognizing that the recovery was to be private-sector led. The Bank was also effective in informally involving some of the brain trusts of universities and the many think tanks in the country. In some areas, additional involvement of non-government stakeholders would have been beneficial. If, for example, private stakeholders who would stand to benefit from the reforms were included more explicitly in the policy dialogue, then more support and more efficient mobilization of pro-reform forces could have occurred. In the case of the audit committee of boards of directors, it might have been helpful for users of financial information, such as institutional investors, to be part of the reform dialogue to argue for independent audit committees. Those groups that would gain would have been better informed as to what was going on, been better able to mobilize more cohesive support, and could have strengthened the World Bank's hand in discussions.

An integrated, comprehensive approach that keeps track of intersectoral linkages and sequencing makes a reform program more effective and sustainable. While the reform program covered a broad spectrum of reforms, individual reform components were subjected to the discipline of a well-integrated and coherent overall reform framework that took account of linkages and priorities and ensured consistency. The program dealt well with corporate and financial sector restructuring and macroeconomic linkages as well as linkages to and within social sector reforms.

A strong up front approach to developing social safety nets is important to building and maintaining public support for the reform program. The SAL II program took into account the need to provide social safety nets to cushion the impact of the crisis and corporate and financial sector restructuring. The program to strengthen the social safety nets was comprehensive and designed in a collaborative process with the Government. The cushion provided by the safety nets proved to be an essential element in public support for the overall reform program.

The ability to identify highly experienced staff within the Bank was critical to supporting the reform program and greatly enhanced its success. Bank staff on the Korea Team were the most experienced in their fields. The availability of these Bank staff for a period of 2 years provided continuity.

It is important for a country that is part of a regional crisis to differentiate itself (positively) if possible. Korea demonstrated that it was reforming at a faster rate and was as serious or more serious than any other crisis country about fundamental structural reforms. In so doing Korea was elevated in the view of the international financial community and avoided being dragged down by other crisis countries that might be struggling and stalling on reforms.

Low public debt, resulting from prudent macroeconomic management, affords a big advantage in dealing with a financial crisis. In responding to the crisis, Korea was fortunate to have a very low level of public debt. This position allowed the Government to play a large and prompt role in recapitalizing the banking sector, which included the injection of W64 trillion to support financial sector restructuring and recapitalization. Korea could also more easily finance a more comprehensive social safety net.

Incentives to carry out the program are not necessarily the same as the incentives faced by Bank counterparts. The audience that the Bank faces in policy discussions is often government officials who may have a conflict of interest with the very substance of the program. Requiring an independent accounting board to oversee the accounting profession, for example, was basically replacing the Government official who was currently responsible for that function, but he was also the same official with whom the Bank was having the dialogue. To overcome this conflict, it is useful to broaden the participation in discussions to include non-government stakeholders who would stand to gain from the reforms.

TA can be critical to implementing components of the reform program and helps broaden the base of the dialogue to include the technocrats who will actually implement the program. In corporate governance, relatively small amounts of TA were able to provide the key studies that supported the design and implementation of reforms. For example, TA funded key reviews and diagnostics for the Korean Accounting Standards Board. In general, in designing an adjustment operation, the dialogue is with a narrow group of key decision-makers.

The Bank might want to find a faster mechanism for TA that supports a large structural, quick disbursing adjustment operation. In addition to the at times slow process at the Bank, the relatively centralized process for allocating TA resources within the Korean Government also made expeditious use of these resources more difficult. Where several implementing agencies are involved, seven in the case of the TA loan for Financial and Corporate Sector Restructuring, a more decentralized approach would facilitate faster implementation of the TA.

At the outset of a crisis, a strong government role can be very good for rapid progress. The Government took a decisive role in restructuring, providing strong leadership to the reform program. This was particularly necessary in corporate restructuring where reform faced strong and powerful entrenched interests. After the initial crisis subsides, a more market based approach can and should evolve.

9. Partner Comments

Recent Economic Performance

Korea's recovery from near collapse has been quicker and deeper than expected, due to the swift implementation of a bold restructuring program fully supported by the international financial institutions (IFIs) and the private sector. In the first quarter of 1999, GDP grew 4.6 percent. In the second quarter, it surged 9.8 percent due to increased domestic demand as well as brisk exports of semiconductors, vehicles and computers. Private consumption rose 7.6 percent and facilities investment surged 24.8 percent in the first half of 1999. The high rate of growth in facilities investment indicated that the recovery would be sustainable. Despite the surge in growth, there has been no inflationary pressure. In fact, in the first eight months of 1999, inflation fell to 0.7 percent, the lowest level in 30 years. The unemployment rate also declined in 1999, falling to 6.2 percent in July after peaking at 8.6 percent in February 1999. The foreign exchange rate continued to show remarkable stability, and thanks to a continued current account surplus and record inflows of foreign capital, the nation's usable foreign reserves rose to an all-time high of U$60.43 billion in July 1999.

Because Korea's currency crisis resulted from a weak financial system, restoring financial soundness was crucial to recovery. Quick moves were taken to overhaul the entire sector, and ailing financial institutions were either closed or merged. In the financial market, great strides have been made on the Korea Stock Exchange. Since hitting a low of 280 in 1998, the stock price index has steadily increased, at one point breaking the 1,000 point on July 7 of 1999, an all time high. Interest rates have remained in the single digits since November 1998. Successful restructuring of the financial sector has stabilized the financial market, lowered interest rates, and improved macroeconomic indicators. Theses favorable economic conditions have, in turn, improved corporate profits and contributed in part to dramatic improvements in corporate capital structures.

Transforming Korea's Economy

The ultimate goal of the structural reforms pursued by President Kim is to establish a new economic paradigm based on market principles. In the financial sector, the focus has shifted to upgrading the software side of the system. The goal is to establish accountable and independent management systems, capable of extending credit to small and medium-sized enterprises with promising technology but no collateral. In the corporate sector, more intensive corporate restructuring is needed to carry out fundamental changes and sharpen the competitive edge of the corporate sector. In today's globalized economy, group-wide management and volume-oriented growth dependent on borrowed capital are no longer viable. Management autonomy, a profit orientation and transparent cooperation among subsidiaries will be key factors in boosting corporate competitiveness and the country's sustainable prosperity. Korea's reform agenda has also been aided substantially by the SAL II program, as the World Bank was firm on policy measures it considered critical for the restructuring of financial and corporate sectors in Korea.

Lessons Learned from the SAL II

Based on its experiences with the SAL II, Korea has come up with a set of recommendations that may aid in designing a better policy framework in the future. First, the role of the World Bank and the IMF during policy matrix consultations should be more reasonably divided, especially with regard to the financial sector. There have been occasions in which each institution has presented us with differing views on the same subject, making it difficult for Korean officials to respond with consistency. Better coordination between the two institutions would have prevented unnecessary complications. Second, country-specific conditions should be more appropriately reflected in the design and implementation of a policy program. In particular, considering that different practices have taken hold in the US, Europe, and Asia over a long period, the best practices cannot be easily put in place within a short period in every client country. Third, the objectives of the SAL II were too ambitious to comprehensively cover all areas of reform. Thus, it may have been more effective if its programs had concentrated on key issues in target areas such as financial and corporate sector reform.

Continuing Tasks for the New Millennium

Korea's resolve does not stop at the achievements of the past two years. In order to sustain economic growth and prevent future crisis, we will continue to push forward with our reform agenda. We are also addressing the inevitable adverse effects of our crisis resolution measures, such as widened income disparities. Furthermore, we are quickly adapting to the changing economic environment marked by the information-technology revolution. This will enable us to build a competitive digital economy and to best meet the challenges of the new century.

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10. Additional Information

NA

Annex 1. Key Performance Indicators/Log Frame Matrix

Outcome / Impact Indicators:

Indicator/Matrix	Projected in last PSR[1]	Actual/Latest Estimate
Refer to SAL II Policy Matrix—Annex 8		

Output Indicators:

Indicator/Matrix	Projected in last PSR[1]	Actual/Latest Estimate
Refer to SAL II Policy Matrix—Annex 8		

[1] End of project

Annex 2. Project Costs and Financing

Project Cost by Component (in US$ million equivalent)

Project Cost By Component	Appraisal Estimate US $million	Actual/Latest Estimate US $million	Percentage of Appraisal
Total Baseline Cost	2,000	2,000	100
Total Project Costs	2,000	2,000	100
Total Financing Required	2,000	2,000	100

Project Costs by Procurement Arrangements (Appraisal Estimate) (US$ million equivalent)

Expenditure Category	ICB	Procurement Method[1] NCB	Other[2]	N.B.F.	Total Cost
1. Works					
No Procurement Categories-- All BOP Support					
2. Miscellaneous					
Total					

Project Costs by Procurement Arrangements (Actual/Latest Estimate) (US$ million equivalent)

Expenditure Category	ICB	Procurement Method[1] NCB	Other[2]	N.B.F.	Total Cost
1. Works					
No Procurement Categories-- All BOP Support					
2. Miscellaneous					
Total					

Project Financing by Component (in US$ million equivalent)

Component	Appraisal Estimate			Actual/Latest Estimate			Percentage of Appraisal		
	Bank	Govt.	CoF.	Bank	Govt.	CoF.	Bank	Govt.	CoF.
BOP Assistance	2,000			2,000			100		

Annex 3: Economic Costs and Benefits

Not Applicable

Annex 4. Bank Inputs

(a) Missions:

Stage of Project Cycle Month/Year	Count	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.) Specialty	Performance Rating Implementation Progress	 Development Objective
Identification/Preparation				
July-August 1998	27	E-3, F-7, Corp.-2, L-1, S-7, CG-2, Comp.-2, Priv.-2	S	S
Appraisal/Negotiation				
September 1998	17	E-2, F-4, Corp.-2, L-1, S-3, CG-2, Comp.-1, Priv.-1	S	S
Supervision				
October 1998-June 1999	17	E-3, F-4, Corp.-2, L-1, S-3, CG-2, Comp.-1, Priv.-1	S	S
ICR				
	13	E-3, F-1, Corp.-2, L-1, S-2, CG-2, Comp.-2	S	S

E-Economist (macro), F-Financial, Corp.-Corporate restructuring, L-Legal, S-Labor market and social safety net, CG-Corporate governance, Comp.-Competition, Priv.-Reform and privatization of SOEs *(b) Staff:*

Stage of Project Cycle	Actual/Latest Estimate	
	No. Staff weeks	Amount (US$ 000)
Identification/Preparation	50.0	221.6
Appraisal/Negotiation	25.7	118.1
Supervision	69.0	309.5
ICR	10.1	37.1
Total	154.8	686.3

Amounts shown differ from those in SAP as they are adjusted for misposting of expenditures that could not be corrected due to the switch to the new SAP system.

Annex 5. Ratings for Achievement of Objectives/Outputs of Components

(H=High, SU=Substantial, M=Modest, N=Negligible, NA=Not Applicable)

	Rating
Macro policies	H
Sector policies	SU
Physical	SU
Financial	SU
Institutional development	SU
Environmental	NA
Social	
Poverty Reduction	SU
Gender	NA
Other	SU
Private sector development	SU
Public sector management	SU
Other	NA

Annex 6. Ratings of Bank and Borrower Performance

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HU=Highly Unsatisfactory)

6.1 Bank performance	*Rating*
Lending	S
Supervision	S
Overall	S

6.2 Borrower performance	*Rating*
Preparation	S
Government Implementation Performance	S
Implementation agency performance	S
Overall	S

Annex 7. List of Supporting Documents

Report of the President-Second Structural Adjustment Loan, October 2, 1998
Loan Agreement (and annexes)
Assessment of Quality at Entry by the Quality Assurance Group-March 5, 1999
Regional Response to Quality at Entry Assessment-April 1999
Nomination for 1999 Awards for Excellence-March 1999
Release of Second Tranche – Waiver of One Condition-April 29, 1999
Press Release February 29, 2000-World Bank Commends South Korea's Progress on Structural Reform
Letter of Development Policy January 2000, Proposed Corporate and Financial Sector Restructuring Loan
Korea Will Continue to Push Economic Reform and Restructuring-Address by President Kim Dae-jung, December 3, 1999

ANNEX 8: STRUCTURAL ADJUSTMENT LOAN II - LETTER OF DEVELOPMENT POLICY AND POLICY MATRIX

Seoul, Korea
September 24, 1998

Mr. James D. Wolfensohn
President
International Bank for Reconstruction and Development
Washington, D.C., 20433

Dear Mr. President:

SUBJECT: PROPOSED SECOND STRUCTURAL ADJUSTMENT LOAN

Letter of Development Policy

1. In response to the economic crisis, the Korean Government embarked on a major structural reform program last December. Since then, we have made substantial progress in the implementation of this reform program, despite a difficult macroeconomic setting and associated social and political pressures. Our commitment to structural reform reflects our conviction that the response to the crisis must not just deal with its immediate symptoms but address its root causes. We fully recognize that fundamental reforms are needed in the incentives and institutional framework to restore Korea's economic performance in today's more integrated and competitive global economy.

2. Our economic reform program has two main objectives: restoring macrofinancial stability while limiting the costs to the real economy and the impact on the vulnerable; and strengthening the economy's structural foundation to lay the basis for resumption of strong and sustainable growth. We have made considerable progress in restoring stability in the foreign exchange market and rebuilding external reserves. However, the impact of the crisis on the domestic economy has been severe. We have responded to this situation by adjusting our macroeconomic policies to mitigate the severity of the recession and support an early recovery of domestic demand, consistent with sustaining the hard-won gains in restoring external financial stability. We will continue to work closely with the IMF in ensuring that our macroeconomic policy framework remains sound and responsive to the economic situation. In the area of structural reform, where we are working closely with the World Bank, we have intensified our efforts in all keys areas of reform, including the reform of the financial system, restructuring of the corporate sector, and strengthening of social safety nets.

3. In the design and implementation of our structural reform program, we have received important support from the World Bank, first through an Economic Reconstruction Loan (ERL) and then a Structural Adjustment Loan (SAL). In recent weeks, we have held intensive discussions with the World Bank, and have reached a common understanding on the next stage of

reforms. Details of policy actions that we will take under the reform program agreed with the Bank are provided in the attached Policy Matrix. As you will see, these actions constitute a strong and comprehensive reform program. We seek World Bank support for this program through a Second Structural Adjustment Loan.

4. Building on the progress made under the previous loans, the program described in the Policy Matrix aims to achieve a major deepening of reforms in three key policy areas: financial sector reform; corporate sector restructuring; and labor market reform and strengthening of social safety nets. In all of these areas, the program includes substantial up-front actions. While the details are provided in the Policy Matrix, allow me to highlight some important elements of the reform program.

5. In the *financial sector*, we are giving priority to the resolution of troubled financial institutions, but are also taking steps to improve the regulatory and institutional framework to support sound development of the financial system in the future. The program includes the following main elements: resolution of weak financial institutions, especially banks, based on a timetable and decision criteria on resolution options agreed with the Bank, and supported by diagnostic reviews and assessment of bank rehabilitation and implementation plans; adoption and application of principles and processes, agreed with the Bank, for the use of public resources in financial sector restructuring and recapitalization and for the management of the acquired assets; enhancement of the independence, authority and institutional capacity of the agency charged with consolidated supervision of the financial sector—FSC; strengthening of prudential regulations, especially those relating to large exposures and connected lending; and development of the capital market through encouragement of new institutional investors (e.g., mutual funds) and asset securitization, standardization of government bond issues, and strengthening of securities market prudential rules and self-regulated organizations.

6. In the *corporate sector*, we have established, in consultation with the Bank, a framework for corporate debt workouts led by creditor banks under guidelines established by the FSC and linked to financial sector restructuring. The workout process will be supported by policies to limit "emergency" loans; reduce cross-guaranties; facilitate debt-equity swaps, asset sales, and mergers and acquisitions; remove tax disincentives; and further improve insolvency laws and procedures. We will ensure that corporate debt restructuring takes place in a market-based manner, through voluntary workouts between corporations and their creditors subject to the rules and guidelines that have been established by the FSC and are described in the Policy Matrix. We will promote corporate restructuring vehicles that are privately financed and managed. We will avoid direct government interventions in the corporate restructuring process that can be distortive and that entail moral hazard. The Government has announced on September 8, 1998 that it will not entertain any demands from the *chaebol* for special financial or fiscal privileges, such as from the top five *chaebol* in support of the recently announced mergers of some of their industrial units known as "big-deals," that depart from the discipline and transparency of the framework for corporate restructuring agreed with the Bank and described in the Policy Matrix.

7. To restore, and sustain, financial viability and competitiveness, Korean firms need both financial and real restructuring. The latter requires improvements in the governance of firms and increased exposure to competitive pressures. Our program for improvements in corporate governance includes strengthening of the responsibilities, independence and accountability of corporate boards; enhancement of minority shareholder and institutional investor rights; and improvement of the legal framework for creditors' rights. Financial transparency and

accountability will be enhanced by the adoption of accounting, auditing and reporting standards for financial institutions and corporations that are consistent with international best practice, strengthening of the internal audit function and the financial oversight role of boards of directors, and enhancement of the role of independent professional bodies in standard-setting and oversight in accounting and auditing. Policies to enhance competition will include strengthening the Fair Trade Act and its enforcement; tightening the regulation of cartels and preventing collusion; ensuring a competitive framework for *chaebol* restructuring; further liberalizing foreign investment; and simplifying import certification procedures. The establishment of holding companies will be allowed in order to provide a more transparent ownership framework for corporate groups.

8. Building on the understandings reached under SAL I, the Government has initiated a major program of reform and privatization of state-owned corporations. The program includes opening the major infrastructure sectors to private participation. In this regard, an important focus of our policy will be the timely implementation of regulatory and institutional reforms in the infrastructure sectors to be privatized in order to ensure that the planned privatization takes place in a transparent and competitive framework and yields maximum efficiency benefits.

9. In the area of *labor market and social safety nets*, our program comprises two main elements: improving the functioning of the labor market to facilitate economic restructuring; and strengthening the social safety net, both to mitigate the social costs of the current crisis and structural change and to make tangible, lasting improvements in Korea's system of social protection. We will fully implement the reform enacted in February this year legalizing layoffs, and will further enhance labor market flexibility by actions to reduce remaining market rigidities. Our labor market agenda also includes strengthening employment services and amending active labor market programs based on a critical review of their cost-effectiveness.

10. With the support of the World Bank, we have substantially strengthened our social safety net programs. With effect from October 1998, unemployment insurance will be extended to firms employing fewer than five workers and to temporary and part-time workers. Contribution rates will be adjusted to maintain the financial viability of the insurance scheme. For those not covered by unemployment insurance, we will expand the public works program and the means-tested non-contributory income support program for the unemployed poor. We are committed to expand in real terms budget allocations for poverty-targeted programs, such as the livelihood protection program, proportionately with any increase in the prevalence of poverty as a result of the crisis. We are also initiating a reform of our health insurance, to increase the protection of poor beneficiaries, improve the coverage of major financial risks, and raise administrative efficiency. Our continuing efforts in pension system reform focus on ensuring the adequacy of "social pension" for the elderly poor, and improving the transparency and efficiency of pension fund management and strengthening links to capital market development.

11. The Government will work closely with the Bank in implementing the reform program described above. To facilitate monitoring of progress on the reforms, we will provide the Bank relevant and timely information on the implementation of policies in all areas covered by the structural reform program and detailed in the Policy Matrix. On progress with corporate debt restructuring within the framework set out in the Policy Matrix, we will provide regular information in accordance with frequency and format agreed with the Bank. We will continue to provide periodic information on key indicators for the financial sector as agreed under the ERL.

Also, we will provide information on selected indicators to help monitor the effects of policy reforms as agreed under the SAL, and on any additional such indicators proposed by the Bank.

12. We reaffirm our commitments made under the ERL and the SAL to halt directed lending and policy loans. We also reaffirm our commitments made under these loans with respect to the transparency of fiscal accounting.

13. In order to promote public awareness of our reform program, we will make full disclosure to the public of the program agreed with the World Bank, including making public the full text of this letter and its attached Policy Matrix and annexes.

14. In conclusion, Korea, under the leadership of President Kim Dae-Jung, remains fully committed to its reform program aimed at bringing about a major restructuring of its economy in order to restore strong and sustainable growth. The World Bank's continuing support to our program would be of invaluable help in enabling Korea meet the challenges of restructuring and achieve its growth and development objectives.

Kyu-Sung Lee
Minister of Finance and Economy

Attachment: Policy Matrix

KOREA - SAL II Policy Matrix
Macroeconomic Framework

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Restoration of financial stability and resumption of sustainable growth.	Sound management of macroeconomic policies—fiscal, monetary, exchange rate, and external debt and reserve management policies—conducive to financial stability and an early recovery of economic activity.	Continued adherence to a sound macroeconomic framework.

KOREA - SAL II Policy Matrix
Financial Sector Reform

Objectives	Policy Measures First Tranche	Second Tranche
Resolution of Weak Financial Institutions		
Develop financial sector restructuring strategy	Further develop and clarify strategy, in consultation with the Bank, including ensuring adequacy of public resources for use in recapitalizing and restructuring the financial system.	Continue to develop strategy (supported by TA). Issue written policies and guidelines consistent with that strategy (ongoing). In consultation with the Bank, adopt process and principles necessary to ensure adequate public resources will be made available by Government in financial system recapitalization and restructuring.
Resolve 5 undercapitalized commercial banks	FSC to agree specific contract terms with acquiring banks and communicate complete contract terms to Bank (August 31). Terms shall include: i) firm agreement on definition of amount and approach to non-performing assets subject to put-back taking into consideration non only past due status, but also qualitative factors affecting loss potential; ii) provision of enough time for acquiring banks to evaluate quality of acquired assets; iii) finality of contractual terms precluding subsequent renegotiation by acquiring banks.	Monitor implementation of contracts and performance (ongoing).
Resolve 7 undercapitalized commercial banks	Banks to submit implementation plans by July 31. FSC to distribute a template for review of implementation plans of the four largest conditionally approved banks to aid in evaluating the feasibility of banks' plans. (July 31). FSC to contract, under TORs agreed with Bank, with international experts to support in-depth analysis of the banks' implementation plans and any other submissions by banks related to the provision of government financial support (September 15). Adopt objectives and principles, acceptable to the Bank, to be used by Government in making decisions on banks' implementation plans, including provision of financial support by Government (August 31).	Announcement by FSC of its decision on implementation plans by September 30 (decision processes supported by domestic and international experts, chosen in consultation with the Bank). Banks whose implementation plans are not approved to be subject to direct recapitalization, mandatory mergers, transfer of business under P&A, or exit under PCA procedures. For banks which are subject to direct recapitalization by government, government will assume the responsibilities of ownership, including contracting with experienced senior managers to undertake restructuring, until sale to strategic investors with sufficient capital and expertise to manage banks. If a plan is approved, the bank will agree on an MOU with FSC covering, among others, recapitalization and merger plans, measures to manage and reduce non-performing assets, and timetable for achieving performance indicators (including capital adequacy targets). Dividend payments to be allowed only when performance indicators are met.

Objectives	Policy Measures First Tranche	Second Tranche
		Banks whose approved plans are not, in the event, achieved will be subject to PCA.
Evaluate remaining commercial banks and take appropriate actions	Initiate diagnostic reviews of remaining commercial banks (on the basis of June 30 data) by internationally recognized accounting firms, signed by domestic and international partners (August 15).	If a commercial bank's capital ratio is found to be below 8% as of end-June 1998, FSC will proceed on a similar basis to that described above for 7 banks (September 30). If the capital ratio of a bank that had been above 8% subsequently falls below 8%, FSC will invoke PCA procedures. Based on the diagnostic review results, administrative guidance to strengthen banks' operations will be provided.
Complete privatization of Korea First Bank and Seoul Bank	Government to agree with the lead manager selected for privatization on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and to authorize lead manager to contact investors (September 15).	FSC/FSB will continue to conduct intensive supervision of these two banks, including in-depth analysis of management capacity, rehabilitation strategy, and financial condition (September 30). Obtain bids for sale of the banks to strategic investors with sufficient capital and expertise to manage banks (November 15); achieve progress, satisfactory to the Bank, toward sale.
Evaluate remaining merchant banks	FSC/FSB to strengthen supervision of existing merchant banks, including conducting on-site examinations to update assessment of financial condition, determine capital ratio integrity, and assess compliance with previously approved rehabilitation plans (August 31).	Implement strengthened supervision (ongoing). Banks falling short of minimal capital adequacy requirements or in substantial non-compliance with previously agreed rehabilitation plans, subject to resolution process.
Review specialized and development banks	Sign contracts for diagnostic reviews, including assessment of asset quality, with internationally recognized accounting firms, as for commercial banks (September).	Complete diagnostic reviews of at least the major specialized and development banks (December 15).
Use of public funds		
Adopt sound principles for the use of public funds in financial system restructuring and recapitalization	Government confirms that public funds will be used only: • in the context of: i) FSC-approved plans developed by banks for restructuring and recapitalization, whether as stand-alone entities	Firm adherence to these principles for the use of public funds (ongoing).

Objectives	Policy Measures	
	First Tranche	Second Tranche
	or via acquisitions or mergers; ii) government takeover of undercapitalized banks; or iii) bank liquidation; • with adequate burden sharing, including contribution of new capital by qualified investors and/or dilution of ownership interests of existing shareholders ; • where acquisition of equity positions in government recapitalized banks will be through a transparent process and open bidding (exceptions to open bidding must have strong justification); • where the bank is making adequate progress on implementation of sound corporate debt restructuring; and • in the context of NBFI resolutions, to cover the difference between explicitly government-guaranteed liabilities and the market value of assets acquired by purchasers, or to payoff explicitly government-guaranteed liabilities in the case of liquidation. Any additional use of public funds for NBFIs will be limited to exceptional cases where failure of these institutions poses a systemic risk. Any such use of public funds would be made in the context of a comprehensive restructuring plan for the relevant NBFI sector.	
Resolve policy issues regarding asset management	Purchases by KAMCO will be at prices that reflect actual and expected recovery rates as well as the opportunity cost of the funds employed for collateralized loans, and nominal prices for unsecured loans (August 31).	Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank (December 15).
Strengthen KAMCO's financial reporting and disclosure	Agree to publish complete semi-annual and annual audited financial statements (which include results of reviews of asset portfolio revaluations) prepared by an audit firm with international experience in asset revaluation (August 31).	Contract with audit firm, with the first audit to be conducted on June 30, 1999 financial statement (December 15).

Objectives	Policy Measures: First Tranche	Policy Measures: Second Tranche
Strengthen KAMCO's infrastructure	Hire qualified experts to assist in the design and implementation of the organizational and operational structure based on TORs acceptable to the Bank (August 31). Contract with data management (MIS) firm with proven track record, according to TORs agreed with the Bank, for installation of asset inventory and management information systems (August 31).	Complete design and agree to implement recommended actions (December 15). Installation of system in process (ongoing). Contract with at least one international asset management company to manage and sell assets, according to TORs agreed with the Bank (October 31), and have the asset management company in place (December 15).
Strengthen Supervision and Regulation		
Strengthen independence and authority of supervisory agencies	Prepare three-year FSB operating budget. Allocate adequate, separate funds for FSB startup costs, and initial operating and extraordinary expenses (including costs of procuring information technology, and TA needs).	Consistent with the Basle Committee's 25 Core Principles for Effective Banking Supervision, enhance independence of FSC/FSB through ensuring operational independence and adequate resources. Issuance and revocation of financial institutions' licenses to be carried out upon recommendation of FSC. Review the adequacy and effectiveness of FSC's governance structure and organization, including the need for greater representation of members nominated by independent associations as the current FSC members' terms expire. Establish the legal framework through which FSB may assess fees on supervised institutions, with revenues specifically dedicated to the operations of FSB. Evaluate funding needs and establish FSB's internal budgetary and funding systems (December 15). Complete unification of supervisory organizations. Enhance consolidated supervision and extend supervisory arrangements for commercial banks to all NBFIs as appropriate (December).
Institutionally strengthen FSC	Request proposal for contract with internationally recognized consultant firm, according to TORs agreed with Bank, to implement the strategic blueprint for FSC/FSB institution building, supervisory consolidation, information technology, upgrade of human resources, and strengthening of supervisory policies and processes (August 31). FSC/FSB to establish and operationalize a special implementation task force fully dedicated to the tasks of agency consolidation and strengthening of supervision and human resources. Task force to report to Chairman of FSC and empowered to access personnel in each of the 4 supervisory agencies (August 31).	Establish management group within FSB and implement enhanced managerial structure (December 15). Implement other major elements of strategic blueprint, including information systems, policies, operational procedures, human resources, and budgetary/administrative functions. Contract signed with internationally recognized consultant firm (September 30) and major elements implemented (December 15).

Objectives	Policy Measures First Tranche	Second Tranche
Enhance supervision	With respect to specialized and development banks, delegate to FSC powers to examine and to make recommendations as to consequential remedial actions for these institutions (August 31).	On the basis of examinations of specialized and development banks at the delegation of MOFE, FSC will make recommendations to MOFE as to any consequential remedial action required (ongoing). FSB to strengthen supervisory policies, processes and procedures for all subject financial institutions, including on-site supervision, off-site surveillance, monitoring, and enforcement.
Upgrade regulation	Issue implementation plan to bring Korea's prudential regulations closer to international practice as expressed in Basle Committee's 25 Core Principles for Effective Bank Supervision (August 15). Plan will cover rules relating to capital definition, loan classification, disclosure of trust accounts, segregation of trust accounts and treatment of trust accounts with guarantees as on-balance sheet items. Submit legislation to amend the Act Concerning the Structural Improvement of the Financial Industry, inter alia, to redefine a "distressed" financial institution so as to allow imposition of sanctions before actual insolvency and to permit the full write down of shareholder equity (August 31).	Issue regulations to extend, effective January 1, 1999, prudential rules applied to commercial banks to specialized and development banks taking into account the special characteristics of the institutions (November 15). Extend connected lending regulations that apply to commercial banks to merchant banks. Adopt timetable for reductions in connected lending limits; connected lending audited and disclosed in annual financial statements (effective January 1, 1999). Submit to National Assembly amendments to General Banking Act, and similar act for merchant banks, to lower single borrower and group exposure limits over time (October 31).
Improve troubled debt restructuring		Issue guidelines by FSC for troubled debt restructuring and workout processes in banks, including best practice regulations regarding treatment of Other Assets Owned (including maximum holding periods, yearly valuations, validation by third-parties, and write-downs, if necessary), workout policies, and asset management plans (October).
Rationalize deposit insurance		Rationalize deposit insurance scheme, including through phasing out of general guarantee (ongoing).
Capital Market Development		
Enhance functioning and competitiveness of securities markets	Strengthen prudential rules for securities markets' activities of all financial institutions, including strengthening standards for internal risk management, adoption of appropriate timetable for moving to mark-to-market accounting for all financial institutions, and use of credit rating (August). Develop implementation plans, with timetable to: i) promote self-regulation, including through delegation of increased regulatory and	Submit to National Assembly necessary changes in Securities and Exchange Law to enhance the role of SROs (December 15).

Objectives	Policy Measures First Tranche	Second Tranche
	supervisory authority to self-regulatory organizations (e.g., KSE, KSDA, KITCA); and ii) reform governance structure of these SROs with the aim to promote their commercial sensitivity and independence (September 15).	
	Develop implementation plan to liberalize trading systems, including allowing for proprietary trading systems, and to strengthen clearing and settlement systems (September 15).	Announce key elements of action plans and achieve progress in implementation (December 15).
Develop bond markets	As outcome of existing task force, create institutional setup to formulate an action plan, with timetable, to develop bond markets (primary and secondary), including: development of a (rolling) three-year plan for central government financing (including funding costs associated with financial restructuring), standardization of new government and government agencies' funding instruments, and consolidation of existing instruments (August).	Announce key elements of action plan with appropriate timetable to develop the bond market, including standardization of new funding instruments and replacement of government-guaranteed bonds with sovereign bonds (December 15). Institutionally strengthen Treasury-functions (December 15). Introduce a framework to develop market-makers network, including adoption of minimum rules and time-table to select primary dealers in government bonds, and authorize banks to act as market-markers in government bonds (December 15).
Develop public asset-liability system	Initiate external debt management component of a comprehensive, integrated external and internal public asset-liability management system (ALM), supported by Bank TA-loan (August).	Implement actions of agreed program on external debt management component and complete report detailing actions with timetable to extend ALM to internal debt and contingent liability components (December 15).
Develop institutional investors	Submit Securities Investment Company Act to allow, among others, the establishment of mutual funds (August). Submit legislation to allow asset-backed securities (August).	

Note: Unless otherwise indicated, actions related to the first tranche release will have been implemented before presentation of the loan to the Executive Directors and actions related to the second tranche release will have been implemented before the release of the second tranche.

Supplement to Policy Matrix on Financial Sector Reform

As part of the Policy Matrix on Financial Sector Reform, the Government is to adopt objectives and principles acceptable to the Bank to be used by the Government in making decisions on the implementation plans of the seven undercapitalized banks, and other banks so identified, including the provision of financial support by the Government. The Government has adopted the following objectives and principles:

Objectives:

- Bring in new private investors with substantial capital at risk, and who are fit and proper and will exert a positive, professional influence on bank governance.
- Bring in new managers with proven technical and managerial skills and experience to operate and restructure banks of comparable size.
- After receiving support, banks are adequately capitalized, have adequate liquidity and are sustainably profitable.
- Banks undergo operational restructuring in a minimum period of time, rapidly implement world-class risk management practices, and resume normal banking activities (e.g., lending to creditworthy firms).
- Government financial assistance to banks provided only where demonstrably less costly to the Government than liquidation.
- Government recovers to maximum extent possible its financial assistance.
- Government sells its ownership interest within shortest period possible.

Principles:

- Provision of financial support to banks by government may include equity capital contributions in the form of cash or interest-paying financial instruments, purchase of loans, purchase of subordinated debt, and/or guarantees on bank assets.
- Government will make transparent the criteria and processes for providing financial support.
- Government will attempt to attract new capital from qualified investors wherever possible, using the provision of financial support as an inducement to new investment where required.
- Government support will be conditional upon approved restructuring ("self-rescue") plans and efforts by banks.
- Government will make transparent its exit strategy, including publicly announcing its commitment to sell its ownership interests as soon as possible.
- Financial support (including direct recapitalization) will be provided only after capital has been adjusted to reflect its true value, taking into account adequate estimates of losses in currently identified non-performing assets (NPAs), as well as losses associated with a further deterioration in loan quality.
- Existing shareholders of undercapitalized banks will suffer a significant dilution of their ownership interests.
- In the case of mergers among undercapitalized banks, the government will provide financial support in an amount necessary to increase resulting bank capital to 10% of risk-adjusted assets based on Basle Committee risk-weighting criteria, and will obtain a substantial interest in the bank (generally 80 or 90% or more).
- In the case of mergers among an adequately capitalized bank and an undercapitalized bank, the government will provide financial support in an amount necessary to increase resulting bank capital to the level of the adequately capitalized bank, which will in all cases exceed 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.
- In the case of an acquisition by an adequately capitalized bank of an undercapitalized bank subject to mandatory transfer (e.g., P&A transactions), the government will provide financial support in an amount necessary to increase resulting bank capital to the level of the adequately capitalized bank,

which will in all cases exceed 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.

- In cases other than mergers and acquisitions as set out above, as an inducement to new equity capital investment the government will provide financial support in the form of equity capital in an amount equal to equity capital contributed by new investors, in order to increase capital to 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.
- In the case of an undercapitalized stand-alone bank where no new third-party investment is involved but the bank is engaged in an adequate, FSC-approved self-rescue effort, the government may provide financial support in a form other than contribution of equity capital.
- In cases other than those set out above, the government will directly recapitalize undercapitalized banks where an analysis is performed demonstrating that liquidation is not a less costly option to government.

KOREA - SAL II Policy Matrix
Corporate Sector Reform
Part A: Corporate Financial Restructuring

Objectives/Policy Measures	First Tranche	Second Tranche
1. Develop framework and capacity to do voluntary corporate workouts		
(a) Provide an overall framework of principles and procedures.	FSC provides guidelines on the following: - selection of corporate restructuring candidates; - a Corporate Restructuring Agreement ("Agreement") to provide a structure for creditor/debtor negotiations; - creation and operation of a Corporate Restructuring Coordination Committee ("Coordination Committee") to resolve inter-creditor disputes; and - "London rules" type principles to guide voluntary corporate workouts (July). FSC to monitor workouts under Agreement to ensure consistency with the issued guidelines for workouts (August).	Continued monitoring of the implementation of the framework and guidelines.
(b) Assign responsibility for leading voluntary corporate workouts.	FSC identifies Lead Banks (July).	
(c) Gain creditor support for approach to voluntary corporate workouts.	FSC obtains adherence of major creditors to Corporate Restructuring Agreement (July).	
(d) Provide necessary professional resources for Lead Banks.	Lead Banks to establish workout units (July). Lead Banks to retain internationally accredited advisors by September 15.	
(e) Provide means to resolve inter-creditor disputes.	Facilitated by FSC, banks to establish a Coordination Committee (July). Coordination Committee to hire staff by August 15 and, as necessary, retain internationally accredited advisors.	
2. Provide policy support for corporate restructuring		
a) Curtail emergency loans.	While financial institutions may provide new or additional loans to distressed but viable corporates as	Monitor observance of the guidelines.

Objectives/Policy Measures	First Tranche	Second Tranche
	part of a Corporate Restructuring Agreement workout, FSC will provide guidelines for such lending by August 15. These guidelines would include the following: - GOK will refrain from directing the banks to make such loans; - the size of any loan would normally be limited to the shortfall needed to meet interest expense and trade payables during the "standstill" period; - in return, the debtor would facilitate complete access by the Lead Bank's financial advisors (e.g., auditors) to the debtor's records; - during the standstill period, the Lead Bank's financial advisors would assess the debtor's viability, review the debtor's liabilities and cash flow projections, and – as appropriate – value assets and indicate how best to maximize the return to creditors – i.e., through voluntary workout, composition, reorganization, or liquidation. In exceptional cases, debtors due to be restructured, but not currently in the workout process, will require new loans. In such cases, if the banks are agreeable to providing such loans they will be provided per the guidelines noted above and for a maximum initial period of six months.	
(b) Facilitate use of debt/equity conversions to address excessive leverage among *chaebol* affiliates.	GOK will review if there are any tax disincentives and regulatory impediments to the conversion of corporate debt into equity or near equity and will submit legislation to National Assembly as necessary (September 15). GOK will submit legislation to National Assembly on mutual funds (August 30). FSC will meet with experienced asset managers, corporate turnaround experts, and investors in distressed securities from the private sector to assess options for "corporate restructuring vehicles" (CRVs). Privately financed and managed, CRVs	

Objectives/Policy Measures	First Tranche	Second Tranche
	would purchase and/or manage corporate equity acquired by financial institutions as a result of debt/equity conversions. Key issues for FSC to discuss with potential CRV managers would include appropriate business forms for CRVs (e.g., partnerships, blind trusts, stock funds) and potential tax, legal, and regulatory issues (August). GOK will identify legal, tax, and regulatory impediments – if any – to the establishment of CRVs (September 15).	Based on this review, and if necessary, GOK will submit legislation to the National Assembly enabling and regulating the formation of CRVs and removing tax, legal, and regulatory impediments to CRV formation and operation (December 15).
(c) Reduce cross guarantees.	FSC will encourage creditors to reduce cross guarantees through voluntary workouts conducted under the Corporate Restructuring Agreement (August). FSC will issue a communication to banks suggesting market-based approaches for "buying out" cross guarantees. These approaches could include, for example, conversion of cross guarantees into guarantor's equity or equity warrants or into a non-guaranteed loan at a higher interest rate (August). FSC will require financial institutions to report on the stock of guaranteed loans to the 64 *chaebol* as of June 30, 1998, by September 15; and ,starting with the fourth quarter of 1998, FSC will require quarterly progress reports from banks on progress in reducing cross guarantees for the 64 *chaebol* (August 15).	Ongoing FSC will establish appropriate internal interim benchmarks to monitor progress toward the reduction of cross guarantees (October).
(d) Provide additional encouragement for corporate mergers and acquisitions, debt restructuring, and asset dispositions as means of corporate restructuring.	GOK to submit to National Assembly proposed package of tax measures to encourage corporate M&As, asset sales and debt restructuring (September 15).	GOK will submit additional legislation to National Assembly removing tax disincentives to corporate M&As, asset disposals, and debt restructuring (December 15).
(e) Improve procedures and coordination for court-supervised insolvency.	GOK will establish a Task Force under TORs acceptable to the Bank to review existing insolvency laws for further improvement, focusing on expedited procedures (e.g., pre-packaged bankruptcies	MOJ will agree to announce, based on the review, its draft amendments to existing insolvency laws designed to promote expedited insolvency procedures for public hearing and subsequent

Objectives/Policy Measures	First Tranche	Second Tranche
	resulting from the workout process) (September 15). FSC and MOJ, subject to agreement with the Supreme Court, will establish a liaison committee comprising these three entities to ensure prompt resolution of issues that affect both voluntary restructuring and court-supervised insolvency (September 15).	submission to the National Assembly by February 1999 (December 15).
3. Accelerate implementation of corporate restructuring		
(a) Complete "triage" analysis.	Lead Banks will complete their assessment of *chaebol* affiliates (including those from the top 5) that have received "anti-bankruptcy" loans or which are on bank "watch" lists and will indicate whether each is best suited for court supervision, voluntary workout under the Corporate Restructuring Agreement, or normal operation (July). A special Task Force has been convened amongst four of the Lead Banks to focus on a system for monitoring the top five *chaebol.* The Task Force will also examine the workout programs of the top five *chaebol.* The Task Force will complete its assessment by end-September.	Monitor follow-up. Monitor follow-up.
(b) Pursue inter-creditor agreements, under the Business Restructuring Agreement, on corporates to be restructured.	First Creditors Council meetings will be convened by each of the Lead Banks under terms of the Agreement (July/August). FSC will direct each Lead Bank to provide monthly reports on the status of corporate workouts (September 15).	Ongoing Ongoing FSC will direct the Coordination Committee to provide monthly reports to FSC on inter-creditor disputes and their resolution (October).
(c) Pursue a timely exit strategy for the 55 non-viable corporates.	FSC will direct Lead Banks to stop new lending and withdraw existing loans for each of the 55 (July).	Lead Banks to provide monthly reports to FSC on progress in exiting the 55.
(d) Identify additional non-viable corporates.	FSC will require monthly updates from Lead Banks on additional corporates identified as non-viable during the course of Corporate Restructuring	Ongoing

Objectives/Policy Measures	First Tranche	Second Tranche
	Agreement workouts (August).	
(e) Initiate resolution of corporates that are not under court supervision, but which have received emergency loans.	FSC will direct Lead Banks to send auditors into *chaebol* affiliates that have received emergency loans – but which are not operating under court supervision – and give the auditors 60 days to review corporate liabilities, cash flow projections, and asset values, assess viability, and indicate how to maximize the return to creditors – e.g., through voluntary workout, composition, reorganization, or bankruptcy (August).	Monitor follow-up.
(f) Expedite resolution of corporates under court supervision in which the GOK is a major shareholder.	KDB will invite international bids under transparent and fair procedures for Kia (July). KFB will invite such bids for Hanbo by September.	Monitor next steps.
(g) Develop an ability to anticipate corporate default or insolvency.	FSC will establish a "situation room" to monitor corporate/financial sector solvency (July).	
(h) Promote self-restructuring by the top 5 *chaebol.*	FSC will provide guidelines to Lead Banks to strengthen the "capital structure improvement plans" of the top 5 *chaebol*, including decreases in debt/equity ratios, disposal of non-viable affiliates, and reductions in cross guarantees (July). Fair Trade Commission will monitor and take actions against the top 5 *chaebol* that engage in anti-competitive intra-group transactions (July).	Monitor implementation of the guidelines. Continued monitoring and enforcement.

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KOREA - SAL II Policy Matrix
Corporate Sector Reform
Part B: Corporate Governance, Competition Policies, and Reform and Privatization of SOEs

Objectives	Policy Measures	
	First Tranche	Second Tranche
Corporate Governance (a) *Corporate Boards and Shareholder Rights*		
Promote effective monitoring of corporate performance.	Submit to National Assembly changes to the Commercial Code to impose on directors and "shadow" directors a duty to act in the interests of the company .	Enact the changes to the Commercial Code.
	Require listed companies to have a minimum of 25% of their boards comprised of outside directors.	
	Submit to National Assembly legislation to further reduce the thresholds for exercise of minority shareholder rights.	Enact the legislation.
	Establish a study team to provide a report and recommendations to Government on the introduction of class action law suits.	Completion of the report and submission of its recommendations to Government on the introduction of class action law suits.
	Establish a study team to provide a report and recommendations to Government on the role and functions of boards of directors.	Complete the report, draft legislation to give effect to its recommendations, and announce a timetable acceptable to the Bank for submission to National Assembly.
	Remove restrictions on the voting rights of institutional investors in listed companies.	
(b) *Legal Framework for Creditors' Rights*		
Improve the insolvency system and strengthen capacity to handle bankruptcy cases.	Creation of bankruptcy commission to assist Seoul District Court by handling aspects of insolvency litigation.	
	Appoint a task force comprising representatives of the judiciary and MOJ under TORs acceptable to the Bank to study the speedy adjudication of bankruptcy cases, including the establishment of one or more specialist bankruptcy courts.	Establish a pilot specialist bankruptcy court in Seoul with dedicated judges.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Facilitate lending to SMEs through improved tools for secured lending.		Establish a Task Force to design a modern system for secured lending on movables and a national registry system. The Task Force to complete its work and make its recommendations by December 15.
(c) *Financial Transparency and Accountability*		
Rationalize the institutional framework for setting standards, regulating and overseeing the accounting and auditing profession.	Establish a Task Force under TORs acceptable to the Bank to review and recommend revisions to relevant laws and regulations to: rationalize the role of various government agencies in supervising the accounting and auditing profession; strengthen the role of KICPA as a self-regulating body consistent with international best practice; and develop an implementation plan for establishing an independent accounting standard setting organization. Commitment to establish an independent accounting standard setting organization by June 1999.	Complete the review and remove all directives affecting accounting and auditing standards and practices by various government agencies including the Bank Supervisory Board and Insurance Supervisory Board and consolidate appropriate regulatory responsibility in the Securities Supervisory Board. Adopt and announce an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999. Submit to National Assembly amendments to applicable laws and regulations to give effect to the recommendations of the Task Force, including changes in CPA Law, External Audit Law, and Securities and Exchange Law.
Strengthen KICPA and make it independent of government and the primary source of guidance in auditing.	Establish a Task Force under TORs acceptable to Bank to: review and strengthen KICPA's charter, operational structure and capacity; assess the appropriateness of rules and regulations on auditing including maximum audit fee, numerical restrictions based on CPA head count, minimum audit contract period, evaluation of audit firms by government, and allocation of audit clients by government; and strengthen KICPA's role in issuing auditing standards, monitoring professional quality, enhancing professional ethics and enforcing the code of conduct.	Complete the review and adopt a time-bound implementation plan satisfactory to the Bank. Begin implementation of recommended changes in rules and regulations. Submit to National Assembly amendments to applicable laws.
Upgrade accounting and auditing standards to make them consistent with international best practice, requiring that financial statements of companies and financial institutions be prepared in accordance with these improved standards with effect from the 1999 reporting year, as agreed under SAL I.		Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year

Objectives	Policy Measures	
	First Tranche	Second Tranche
		1999. The improved accounting standards will include, inter alia, standards covering financial instruments, leases, asset classification, troubled debt restructuring, asset revaluation, translation of foreign currencies, loss and income recognition, financial statement disclosure, and combined financial statements.
Improve the financial oversight role of boards of directors and enhance the effectiveness of the internal audit function.	Complete the study on introduction of audit committees of boards of directors and improvement of the effectiveness of the internal audit function for listed companies and financial institutions under TORs acceptable to the Bank, as agreed under SAL I.	
	Appoint a Task Force under TORs agreed with the Bank to: review and rationalize the function of the audit selection committee to make it an independent and transparent entity and develop an implementation plan to upgrade it to an audit committee of boards of directors, taking into account the conclusions of the above study; and recommend changes in relevant laws and regulations.	Completion of the review. Adoption and announcement of an implementation plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.
Improve the quality and frequency of financial reporting by listed companies.		Require listed companies to publish quarterly financial statements with adequate disclosure consistent with international best practice starting in 2000 Q1.
<u>Competition Policies</u> Increase competition across all sectors.	Complete draft of amendments to Fair Trade Act (FTA), acceptable to the Bank, based on recommendations of the Joint Public/Private Sector Committee.	Enact the amendments.
	Commitment to fully enforce provisions of the FTA in the restructuring of chaebols in accordance with the policy statement issued under SAL I.	KFTC to provide the Bank with a detailed report and analysis of all cases of chaebol M&A, divestiture and restructuring notified and considered prior to the second tranche release, in a format agreed with the Bank. Enact the Act on Comprehensive Regulation of Cartels. Review and propose revisions as required to the GOK procurement guidelines to assure transparency, and limit opportunities for collusion and corruption.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	Issue and implement comprehensive M&A guidelines.	Monitor compliance, especially in chaebol restructuring.
Strengthen the enforcement of rules limiting transactions between related corporations, companies, financial institutions, their owners, directors, shareholders and employees.		Apply existing laws stringently and uniformly, and propose amendments to the FTA to further limit such transactions.
Establish a more transparent framework for corporate group rights and obligations.		Enact legislation, satisfactory to the Bank, modifying restrictions under the FTA on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.
Strengthen the operational capacity of KFTC.	Implement the agreed work plan for the Policy Analysis and Evaluation Group.	Develop detailed KFTC operational guidelines (e.g., investigative guidelines) and achieve satisfactory progress in implementing an appropriate upgrading program.
Further deregulate domestic industry to promote competition.	Complete submissions to the Deregulation Committee on regulatory barriers in different industries.	Achieve satisfactory progress in implementing necessary legislative or regulatory changes.
Promote foreign direct investment.	Enact the Foreign Investment Promotion Act.	Implement the new Act (simplification of procedures, improved support system).
Support competition in domestic industry by easing import requirements and administration.	Review customs clearance and product certification/registration procedures and develop a plan to streamline them.	Achieve satisfactory progress in implementing the streamlining plan.
<u>Reform and Privatization of SOEs</u> (a) *SOE Restructuring and Governance Reforms*		
Ensure that SOEs that are to remain under state control or are to be privatized gradually, operate in an efficient and accountable manner.	Review the Basic Law on Management of "State-Capitalized" Enterprises in order to improve management structure of such SOEs, including the allocation of policy, regulatory and ownership functions.	Submit to National Assembly legislation to improve the management structure of SOEs.
(b) *General Privatization Program*		
Ensure that the Government's	Announce a program of privatization, including	Submit any necessary privatization legislation, including

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
proposed privatization and SOE reform program is implemented within a sound framework.	identification of SOEs to be offered for sale, extent of proposed share or asset sales and, as appropriate, proposed methods and target schedule for the completion of such proposed sales. Establish a steering committee, supported by task forces, to oversee implementation of the privatization program. Review need for any enabling legislation.	amendments to the privatization law, to National Assembly.
(c) *Infrastructure Sectors*		
Improve regulatory and institutional framework for increased private participation in the provision of infrastructure services.	Adopt and announce an overall strategy acceptable to the Bank for dealing with structural, regulatory and institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.	Satisfactory progress in implementing the privatization and SOE reform progr[illegible] in infrastructure sectors in accordance with the principles included in the strategy statement.
	Undertake a study on reforms to the regulatory and institutional framework for involving private participants in greenfield infrastructure projects.	Announce key elements of proposed reforms.
Telecommunications	Undertake a study on reforms to pricing, interconnection and universal service arrangements, and the establishment of an independent regulatory authority.	Announce key elements of proposed reforms, including timetable for implementing those reforms, prior to any further privatization of KT and, in any case, before December 15.
Power	Undertake a study on structural and regulatory reforms in the power sector, including the establishment of an independent regulatory authority.	Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms.
Gas	Undertake a study on structural and regulatory reforms in the gas sector, including the establishment of an independent regulatory authority.	Announce preliminary findings of the study by December 15. Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms, before proceeding with the privatization of KOGAS.

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KOREA - SAL II Policy Matrix
Labor Market and Social Safety Nets

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Integration of Social Policy Reform Agenda Improve the framework for the design and coordination of social safety net policies.	Commitment to clearly mandate and adequately staff the National Committee on Social Security chaired by the Prime Minister, to coordinate cross-cutting reforms in social policies in order to achieve coherence across concerned ministries and agencies.	Establishment of a Working-Level Committee under the National Committee on Social Security, anchored in the Prime Minister's Office and provided with adequate professional staff capacity, to serve as a focal point. Complete interim assessment report on cost-effectiveness of integrating contributions to social risk management funds for pensions, medical insurance and unemployment insurance, including: (a) collection mechanisms; (b) contribution base determination; and (c) cross-checking features. Complete interim assessment report on the aggregate payroll tax and labor market implications of adjustments in coverage and contribution rates for pensions, medical insurance and unemployment insurance.
Social Protection for Workers Expand sustainable coverage of income support provided by the unemployment insurance (UI) component of the Employment Insurance Scheme (EIS).	Extend UI to firms with fewer than 5 workers and to temporary and part-time workers with effect from October 1998. Commitment to maintain actuarial integrity of the UI scheme, i.e. positive financial reserves, and zero leakage to other programs (per SAL I agreement).	Adjust contribution rates if necessary in order to maintain financial viability of UI scheme for FY99 given anticipated unemployment rate and any changes in benefit structure (per SAL I agreement).
Increase employment by enhancing labor market flexibility.	Commitment to implement fully the layoff provisions of the 1998 Labor Standards Act so as to remove undue labor market impediments to efficient corporate restructuring.	Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility. Complete report providing recommendations for appropriate expansion of public employment services without crowding out private employment services.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Improve efficiency of active labor market programs by eliminating cost-ineffective programs provided under the employment security (ES) and vocational ability development (VAD) components of EIS.	Commitment to limit expenditure on ES and VAD programs by containing contribution rates at or below current levels (0.3% for ES and averaging 0.4% for VAD) and maintaining positive financial reserves. Commitment not to provide budget subsidies that increase the scope of ES and VAD activities beyond self-financed operations. Commitment not to expand coverage of ES and VAD programs any further. Finalize TOR acceptable to the Bank and initiate formal evaluation of cost-effectiveness of ES and VAD programs	Complete interim evaluation report on the cost-effectiveness of ES and VAD programs (per SAL I agreement). Hold national workshop with stakeholders to discuss the interim evaluation report. Disseminate the interim evaluation report. Announce policy adjustments to eliminate ES and VAD programs found to be cost-ineffective
<u>Protecting the Poor</u> Expand provision of workfare for the unemployed who are not insured.	Implement expanded Phase II of the temporary public works program at wage levels designed to target the poor jobless by self-selection. Restrict participation to the unemployed who are not currently eligible to receive UI benefits.	Allocate adequate FY99 budget to absorb supply of labor forthcoming for public works at targeted wage levels (not higher than Phase II in real terms). Relax capacity constraints on workfare expansion by involving NGO and private sector contractors.
Expand provision of means-tested noncontributory income support for the poor.	Commitment to expand budget allocation in FY99 to the temporary noncontributory means-tested allowance for the unemployed poor in line with increases in the eligible target group. Commitment to expand budget allocation in FY99 to workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program for the poor.	Allocate adequate FY99 budget. Allocate adequate FY99 budget.
Maintain real expenditure per eligible beneficiary on existing livelihood protection programs for the poor (self-support, home care and institutional care programs).	Initiate analytical report assessing trends in the 1998 inflation rate adjusted for consumption patterns of poor households. Initiate analytical report assessing 1998 trends in the number and characteristics of people living in poor households.	Complete the two reports by October 30. Allocate adequate FY99 budget taking into account: (a) adjustment of nominal per capita benefits to compensate for inflation among the poor; and (b) adjustment of total budget to absorb increased number of eligible poor.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Strengthen information base for regular poverty monitoring and analysis.	Implement special National Survey of Employment Assistance and Welfare Needs of the Unemployed (KIHASA/KLI/NSO collaboration). Assign institutional responsibility for coordinating interagency inputs to design of an integrated multipurpose national household survey.	Hold national workshop to review design options for a regular national multipurpose household survey, including a panel subsample, incorporating comprehensive data on household welfare and coverage of government programs. Complete feasibility report for introducing a regular national multipurpose household survey, including questionnaire design, sample size, field operations, policy analysis and institutional responsibilities.
<u>Financial Risk Management for Health</u> Improve efficiency of financial intermediation by public sector health insurers through reducing the unit costs of administration per insured under the national Medical Insurance System (MIS).	Complete prospective assessment report on cost-effectiveness of alternative options for consolidation of the fragmented insurance societies belonging to Self-Employed Medical Insurance (SEMI) component of MIS. Commitment to incorporate the financial operations of MIS into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Implement consolidation plan for insurance societies under SEMI.
Strengthen supply-side incentives for efficient provision of medical care.	Commitment to implement a universal reform of the provider payment system to improve cost containment incentives based on DRG-based pricing.	In consultation with the Bank, announce a detailed timetable for implementation of the provider payment reform plan beginning with the year 2000.
Improve demand-side protection against major financial risks for MIS beneficiaries and for poor Medicaid beneficiaries by reducing out-of-pocket copayments.	Commitment to significantly reduce by FY2000 the effective coinsurance rate for hospital inpatient care, combined with an income-related catastrophic cap, both for MIS and Medicaid. Initiate preparation of a coinsurance reform plan, both for MIS and Medicaid, including adjustments to special treatment changes, inclusion of noncovered services, and reallocation of health insurance coverage from minor to major risks.	Adopt and announce key elements of the coinsurance reform plan, both for MIS and Medicaid, including the timetable for implementation beginning with FY2000.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	Commitment to harmonize Medicaid provider reimbursement levels with MIS. Implement an official investigation of leakages of allocated budget funds from reaching poor beneficiaries of the Medicaid program.	Commitment to allocate adequate FY2000 budget to implement provider reimbursement reform for Medicaid beneficiaries. Complete investigation report and initiate implementation of its recommendations.
Diversify policy instruments for pooling financial risks of medical care.	In consultation with the Bank, finalize TORs and initiate evaluation report on introduction of individual medical savings accounts (MSAs) to finance intermediate financial risks associated with medical care.	Hold public workshop to review findings and recommendations of assessment report on introduction of MSAs.
<u>Social Protection for the Elderly</u> Mitigate impact of the economic crisis on living standards of the elderly.	Initiate analytical report assessing the effectiveness of the means-tested noncontributory "social pension" for elderly aged over 65 in terms of coverage of the target group, and prevention of poverty among recipients.	Complete the analytical report and allocate adequate FY99 budget for the social pension to achieve effective coverage of the poor elderly target group.
Improve transparency and governance of financial operations of all public pension schemes (NPS and occupational schemes for civil servants, teachers and military).	Commitment to establish an Office or function of the Actuary in the Office of the Prime Minister responsible for annual projections of the long-term actuarial status of all public pension schemes based on consistent macroeconomic and demographic assumptions. Commitment to incorporate the financial operations of the Teachers and Civil Servants pension schemes into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Establish the Office/function of the Actuary. Allocate adequate FY99 budget to prepare and publish the first annual status report for FY98.
Develop an integrated pension reform proposal that fully recognizes and rationalizes the mandatory public and private components of the existing pension system.	Finalize TORs acceptable to the Bank governing the structure, composition and mandate of the Government Task Force responsible for the planned comprehensive White Paper on Pension Reform (per SAL I agreement).	Establish the Government Task Force by October 1998 (per SAL I agreement). Commitment to complete draft White Paper no later than November 1999 (with background papers completed by June 1999) on an integrated pension reform package combining public/private and mandatory/voluntary pensions pillars designed to attain: (a) a reasonable replacement rate target for the average worker; (b) reasonable protection from poverty for the aged; and (c) long-term financial sustainability. Completion of progress report on the work program of the Task Force.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Achieve more efficient allocation of National Pension Fund (NPF) assets.	Adopt and announce a timetable for implementation of the reduction in forced government appropriation of the flow of NPF surpluses (per SAL I agreement) as follows: 65% of the NPF surplus flow in 1999, 40% in 2000, 20% in 2001 and 0% in 2002. Announce that the stock of outstanding loans to government from NPF will be repaid in full at maturity without rollovers.	Implement the phased reduction of forced government appropriations from NPF agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act. Implement plan to strengthen the professional investment unit in the National Pension Corporation (per SAL I agreement), including: (a) achievement of a high standard of staff qualifications and supporting technology; and (b) adequate resources to monitor external fund managers.
	In consultation with the Bank, announce specific guidelines for governance of NPF reserves, including: (a) the task of the asset management committee; (b) investment rules and rating procedures; (c) benchmarking and reporting mechanism; and (d) index-based criteria for selecting external fund managers.	Announce a schedule acceptable to the Bank for contracting out asset management and implement plan to increase gradually and substantially the share of NPS assets outsourced to external fund managers (per SAL I agreement), including: (a) increased unit amount outsourced per external fund manager in order to attract interest of reputable firms; and (b) adoption of revised criteria for selecting and recontracting external fund managers to reflect diversification of investment risks. Commitment to: (a) phase out per agreed timetable all lending from NPF to program participants using their contributions as collateral; and (b) refrain from providing financial assistance from NPF to restructuring of financially distressed corporations

Note: Unless otherwise indicated, actions related to the first tranche release will have been implemented before presentation of the loan to the Executive Directors and actions related to the second tranche release will have been implemented before the release of the second tranche.

ANNEX TO THE SAL II POLICY MATRIX
CONDITIONS FOR BOARD PRESENTATION AND SECOND TRANCHE RELEASE

The full program of policy actions to be supported by SAL II is set out in the SAL II Policy Matrix. Within this full program, a subset of key policy actions has been identified whose implementation will be a condition for Board presentation and second tranche release. Besides these specific policy actions, a general condition will be that the implementation of the full program is satisfactory overall.

Conditions for Board Presentation

Within the full program detailed in the policy Matrix, the following will serve as conditions for Board presentation:

- Adoption of objectives and principles acceptable to the Bank to be used by the Government in making decisions on the implementation plans of the seven undercapitalized banks, and other banks so identified, including the provision of financial support by the Government.

- Agreement between the Government and the lead manager selected for the privatization of Korea First Bank and Seoul Bank on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and authorization to the lead manager to contact investors.

- Adoption of principles acceptable to the Bank governing the use of public resources in financial system restructuring and recapitalization.

- Issuance of guidelines to financial institutions by FSC, satisfactory to the Bank, limiting the extension of "emergency" loans to corporations.

- Commitment to establish an independent accounting standard setting organization by June 1999.

- Adoption and announcement of an overall strategy acceptable to the Bank for dealing with structural, regulatory and institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.

- Extension of unemployment insurance to firms with fewer than five workers and to temporary and part-time workers, with effect from October 1998.

- Adoption and announcement of a timetable agreed with the Bank for the reduction of forced government appropriation of the flow of National Pension Fund surpluses, and announcement of the Government's commitment that the stock of its outstanding borrowings from NPF will be repaid in full at maturity without rollovers.

Conditions for Second Tranche Release

Within the full program detailed in the Policy Matrix, the following will serve as conditions for release of the second tranche, in addition to the general requirement of overall satisfactory progress in carrying out the full program.

- Maintenance of a sound macroeconomic framework, consistent with the objectives of the Program, as determined on the basis of indicators agreed to by the Borrower and the Bank.

- In consultation with the Bank, adoption of process and principles necessary to ensure that adequate public resources will be made available by the Government for use in financial system recapitalization and restructuring.

- Achievement of progress, satisfactory to the Bank, toward sale by the Government of majority ownership in Korea First Bank and Seoul Bank through a biding process satisfactory to the Bank.

- Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank.

- (a) Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year 1999. (b) Adoption and announcement of an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999.

- Adoption and announcement of a plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.

- Enactment of amendments to the Fair Trade Act, acceptable to the Bank, to enhance competition in the domestic economy, based on the recommendations of the Joint Public/Private Sector Committee.

- Enactment of the Act on Comprehensive Regulation of Cartels.

- Enactment of legislation, satisfactory to the Bank, modifying restrictions under the Fair Trade Act on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.

- Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility.

- Allocation of amounts in the 1999 budget sufficient to: (a) expand the public works program to absorb the supply of labor forthcoming at targeted wage levels (not higher in real terms than under Phase II of this program); (b) expand the provision of means-tested non-contributory income support for the unemployed poor in line with the increase in the eligible target group; (c) expand workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program; and (d) at least maintain in real terms the level of expenditure per beneficiary under the existing livelihood protection programs for the poor.

- Implementation of the phased reduction of forced government appropriations from the National Pension Fund agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act.